Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FS:LI:POSTF-104267-02
DRMirabito

date: September 26, 2002

to: Mary Faraldo, Group Manager, Group 1569
Attention: Mary Anne Casella, Revenue Agent, Group 1569

from: Jody Tancer, Associate Area Counsel
(Financial Services:Long Island)

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subject: [redacted]
EIN [redacted]
[redacted]

You requested advice regarding whether [redacted] (the taxpayer or [redacted]) accounting methods regarding deferral of gift certificate income conform with the provisions of Treas. Reg. § 1.451-5. This memorandum should not be cited as p edent.

ISSUES

1. May the taxpayer defer recognizing income from gift certificates under Treas. Reg. § 1.451-5?

2. Has the taxpayer properly elected to defer income from gift certificates under Treas. Reg. § 1.451-5(d)?

CONCLUSIONS

1. The taxpayer may not defer recognizing income from gift certificates sold in the taxable year [redacted].

2. [redacted] has not properly elected to defer income from gift certificates under Treas. Reg. § 1.451-5(d).

FACTS

The facts, as we understand them, are as follows:

e taxpayer is the parent of a consolidated group of restaurants; per Fc s 851 attached to the subject return, there are [redacted] subsidiaries. On th consolidated group Form 1120 for the taxable year [redacted], the taxpayer r [illegible]ts the following items of income per the accrual method of accounting: gross receipts or sales ($[redacted]); interest ($[redacted]); and other income ($[redacted]). Attached to the return are Statements [redacted] through [redacted], identifying the items of other income and providing the appropriate amount for each subsidiary: management fee; development fee; sundry; lamp sales net; steak knives sales net; tobacco sales net; miscellaneous; service charge revenue; checkroom; concession fee; and, use fee. No further information on any item of income was provided on Form 1120. Miscellaneous income of $[redacted] was reported for one subsidiary.

Beginning with Statement 157, the taxpayer also attached to the return amounts for the subsidiaries pertaining to items on Schedule L. The Statements included amounts for such categories as:

1. Trade Notes and A/R.

2. Other Current Assets; per Statements [redacted] through [redacted], Other Current Assets included accounts receivable other; intercompany; prepaid expenses; merchandise inventory; and/or intercompany payable. No further information on any category was given.

3. Other Assets; this category included long term notes receivable; c[illegible]r noncurrent assets; deferred assets and fees; rent abatements net; c[illegible]/value life insurance; security deposits; smallwares; trademarks; liquor license; and/or temp. Again, only the amount of a particular item was listed without further information.

3. Accounts Payable.

4. Other Current Liabilities; included accrued expenses & taxes; current portion cap leases & notes; intercompany payables; customer payables; employee payables; and/or cash overdraft. Some, but not all, of the subsidiaries included an amount for customer payables and/or intercompany payables.

5. Other Liabilities; this category included restructuring debt; deferred income; noncurrent portion cap leases; and accrued lease amortization. Amounts only were listed.

Beginning with Statement [redacted], amounts were listed for Schedule M, line 5-Expenses on books not deducted on return; these items included officers life insurance; lease auto inclusion; reserve for asset write downs; amortization; work opportunity credit wage reduction; management fees; admin reimbursements; s/l lease amortization; FICA credit p/r tax adjustment; and/or admin allocation. Similarly, beginning with Statement 24° amounts were listed for Schedule M-1, line 8-Deductions on return not c[illegible]ged against book, including state taxes; stock option compensation; le[illegible]l fees/litigation expense; other expenses; startup costs-noncapital;

s ion 481 pickup on cost segregation; foreign currency losses; a ization; management fees; admin allocation; other tax deductions not recorded on books; restructuring costs; restructuring costs paid against reserve; and capital loss carryover utilized in the current year. No further explanation or detail of any item was included.

Two other attachments to the return are significant. The taxpayer attached a Form 3115, Application for Change in Accounting Method, seeking approval to change its accounting method for depreciation or amortization. It also attached a Form 8832, Entity Classification Election, for a subsidiary located in [redacted]. Through this form, the taxpayer sought to elect an initial classification by a newly-formed entity for a foreign eligible entity with a single owner electing to be disregarded as a separate entity.

As part of her audit of the taxpayer's [redacted] taxable year, the revenue agent questioned its treatment of gift certificate income. These numbered certificates may be bought and redeemed at any of the consolidated group's restaurants. Each certificate states, "[redacted]." We understand that despite the above statement, certificates will still be honored by some subsidiaries beyond the one year expiration date. According to the t ayer, although the certificates are sequentially numbered, when a p icular restaurant receives additional blank certificates from the [redacted] office, the new certificates would not necessarily follow the previous certificates in number sequence. Periodically, redeemed gift certificates were mailed to the [redacted] office. In addition, redemption records were maintained, including the number of each gift certificate, the name, dollar amount, and date of redemption.

An IDR issued to the taxpayer requested this information:

1. A description of the taxpayer's method for reporting gift certificate sales and redemptions, including unredeemed certificates and certificates sold at a discount to individuals, corporations or organizations.

2. A description of the book and tax entries made to account for all gift certificate activities.

3. How the taxpayer tracked unredeemed certificates.

4. How [redacted] tracked discounts on the gift certificate sales.

5. Why the taxpayer failed to file and/or attach to its Form 1120 a statement pursuant to Treas. Reg. § 1.451-5(d).

) How [redacted] tracked the information required by Treas. Reg. § 1.451-5( ).

The taxpayer's accountant provided the following in response:

1. Journal entries purporting to explain bookkeeping entries for regular sales, discount sales, redemption, and expirations.

2. That there was no difference between the taxpayer's book and tax treatment of gift certificates. When a gift certificate expired, entries wee made in the general journal to reflect recognition of previously deferred revenue. In addition, all credit entries were for the sales of the certificates and debits reflected the redemption or expiration of gift certificates.

3. Gift certificate liabilities were determined by using a percentage, determined by past experience, applied to sales during the December holiday period. Accordingly, an average deferral of less than [redacted] months occurred. However, we understand that at least [redacted] were not open for all [redacted] months in [redacted].

4. Discounts were debited to a current asset account, usually prepaid marketing expense, that was then amortized pro rata over a twelve month period. Thus, as the certificates were either redeemed or charged off in less than twelve months, the discounts actually remained outstanding after the income was recognized and resulted in an understatement of expense. According to another document provided to us, gift certificates are included in other current liabilities. However, per the Form 1120 as noted above, prepaid marketing expense might be reported by some subsidiaries as either other current assets (prepaid expenses) and/or other current liabilities (accrued expenses). The return itself contains insufficient information to determine how the gift certificates were treated as no specific mention of items pertaining to gift certificates is made. In addition, according to the pertinent Statements attached to the Form 1120, not every subsidiary listed accrued expenses in its amount of other current liabilities, although each subsidiary could sell and redeem gift certificates.

5. The omission of the required statement was only an oversight. Since the current procedures had been used for more than ten years, the taxpayer took the position that any change from the procedures described could be considered a change in acting method requiring the Commissioner's consent. Further, according to the taxpayer, the regulations do not state that the required statement is necessary to properly defer income. In addition, the taxpayer contended that the information required by Treas. Reg. § 1.451-5(d) was previously provided during the examination. We understand that this previous submission is contained in a one-page listing of the taxpayer's [redacted] gift certificate activity; the document lists named subsidiaries and contains columns for beginning balance, certificates sold, certificates redeemed, certificates expires/adjustments, December adjustment, balance, December [redacted] sales, and percentage of [redacted] sales deferred at [redacted]. We are unsure whether the document provided to us

w- prepared by the taxpayer or by the revenue agent from information p- ided by the taxpayer.

6. Information was tracked through each [redacted] sales and general journals. When certificates were sold, a credit to the deferred sales (liability) account was recorded in the sales journal. Conversely, when certificates were redeemed, the deferred sales account was relieved to the credit of the current sales account in the sale journal. At year-end, any needed adjustments were made through the general journal.

Based on information received from the accountant, the revenue agent was able to track several, although not all, of the debit and credit entries from the trial balance/general ledger account gift certificates. Moreover, she determined that the taxpayer's accounting for the certificates was not always consistent with the entries presented. According to her analysis, the taxpayer currently recognizes the amortization of discounts as an expense but defers the matching certificate income until redemption. In addition, the revenue agent is unsure from the taxpayer's records and information how much, if any, gift certificate income was reported on the Form 1120 for the [redacted] taxable year. We assume for purposes of the Analysis below that the taxpayer had unrestricted use of the gift certificate income.

ANALYSIS

1. Issue 1: May the taxpayer defer income from gift certificates under Treas. Reg. § 1.451-5?

Internal Revenue Code § 446 provides that a taxpayer's computation of taxable income shall be made under such method as, in the opinion of the Secretary, clearly reflects income when its method does not clearly reflect income. Further, per Treas. Reg. § 1.446-1(a)(2), acceptable methods of accounting clearly reflect income. Courts have consistently interpreted the statute and regulation as giving the Commissioner broad discretion to ignore a taxpayer's method if such method does not clearly reflect income. Thor Power Tool v. Commissioner, 439 U.S. 522 (1979).

Internal Revenue Code § 451 provides generally that the amount of any item of gross income shall be included in gross income for the taxable year in which received by the taxpayer unless, under the usual method of accounting used by the taxpayer in computing taxable income, the recognition is properly accounted for as of a different period. Per Treas. Reg. § 1.451-5(b), adopted March 23, 1971, advance payments must be included in income either in the taxable year of receipt or, except as provided in paragraph (c) of that regulation, may be deferred for a certain period as discussed in the following paragraph. Treas. Reg. § 1.451-5(a)(1) defines advance payment as any amount received in a taxable year by a taxpayer using an accrual method of accounting for purchases and sales p' ant to, and to be applied against, an agreement for the sale or other d sition in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of trade or business. Further, § 1.451-5(a)(2) includes gift certificates redeemable for goods as an "agreement."

Alternatively, § 1.451-5(b)(1)(ii)(a) permits the inclusion of advance payments in income in the tax year in which properly accruable under the taxpayer's usual method of accounting if such method results in including the advance payments in gross receipts no later than the time such advance payment are included in gross receipts for purposes of all the taxpayer's reports to shareholders and for credit purposes. Consolidated financial statements are reports to shareholders under this regulation. In addition, under § 1.451-5(b)(1)(ii)(b), if the taxpayer's method of accounting for purposes of such reports results in any portion of advance payments being included in gross receipts earlier than for tax purposes, the advance payments must be included in income in the taxable year in which includible in gross receipts pursuant to the method of accounting for purposes of such reports.

§ 1.451-5(c), exception for inventoriable goods, provides for deferral of income recognition where the taxpayer:

- receives an advance payment in a taxable year with respect to an agreement such as a gift certificate, which can be satisfied with goods or a type of goods that cannot be identified in such taxable year, and

- on the last day of such taxable year the taxpayer: (1) is accounting for advance payments pursuant to a method described in paragraph (b)(1)(ii) of this section for tax purposes, and (2) has received substantial advance payments as defined in subparagraph (c)(3), and

- has on hand or available through the normal source of supply goods of substantially similar kind and in sufficient quantity to satisfy the agreement in such year.

When all the requirements of subparagraph (c) are met, then all advance payments received with respect to such gift certificates must be included in income by the last day of the second taxable year following the year in which substantial advance payments are received, and not previously included in income under the taxpayer's accrual method of accounting. § 1.451-5(c)(3) provides that advance payments received in a taxable year with respect to a gift certificate under which the goods or type of goods to be sold are not identifiable in such year shall be treated as "substantial advance payments" when received.

I think that [redacted] may not defer recognition of gift certificate income from the taxable year [redacted] for these reasons:

1. [redacted] has not provided any information permitting the revenue agent to determine that its method of accounting meets the requirements of Treas. Reg. § 1.451-5(b)(1)(ii).

2. Due to its failure to meet the requirements of Treas. Reg. § 1.451(b)(1)(ii), the taxpayer also fails to meet the requirements of Treas. Reg. § 1.451-5(c). Please note that we assume for purposes of this conclusion that the taxpayer has met the other requirements under § 1.451-5(c), that it has entered into an agreement which can be satisfied with goods that cannot be identified in the taxable year [redacted] and that it has on hand or available through its normal source of supply goods of substantially similar kind and in sufficient quantity to satisfy the gift certificates in [redacted].

Although it is difficult for us to understand certain of [redacted] positions as expressed in its response to the IDR, it appears that one of the taxpayer's arguments is that its accounting method reflects the consistent application of generally accepted accounting principles and thus clearly reflects income; see IDR response 2. above. From its response, we think the taxpayer is attempting to use Treas. Reg. § 1.446-1(a)(2) for support. However, the court in Straight v. Commissioner, T.C. Memo. 1997-5 rejected another taxpayer's reliance on that regulation. Rather, an accounting method conforming with GAAP does not necessarily clearly reflect income for tax purposes since tax and financial accounting have different objectives. See Thor Power Tool Co. v. Commissioner, 439 U.S. at 540-544; Schlude v. Commissioner, 372 U.S. 128, 134 (1963).

2. Issue 2: Did the taxpayer properly elect to defer income from gift certificates under Treas. Reg. § 1.451-5(d)?

Given our conclusion above that [redacted] may not defer gift certificate income under § 1.451-5, we would not necessarily analyze whether the taxpayer properly elected to defer its income under Treas. Reg. § 1.451-5. However, since the taxpayer has asserted that its omission was inadvertent in paragraph 5. of its response to the IDR, you may find the analysis below useful in responding to the taxpayer on this point.

Significantly, Treas. Reg. § 1.451-5(d) states

> If a taxpayer accounts for advance payments pursuant to paragraph (b)(1)(ii) of this section, he must attach to his income tax return for each taxable year to which such provision applies an annual information schedule reflecting the total amount of advance payments received in the taxable year, the total amount of advance payments received in prior taxable years which has not been included in gross income before the current taxable year, and the total amount of

such payments received in prior taxable years which has been included in gross income for the current taxable year.

In general, substantial compliance with election requirements occurs when, at a minimum, the taxpayer clearly expresses its intention to make the election and be bound thereby on either the original return or, if the circumstances necessitating an election arise after the filing of an original return, as soon as practicable on the amended return. Knight-Ridder Newspapers v. United States, 743 F.2d 781 (11th Cir. 1984); Fischer Industries, Inc. and Subsidiaries v. Commissioner, 87 T.C. 116 (1986), aff'd, 843 F.2d 224 (6th Cir. 1988); Atlantic Veneer Corporation v. Commissioner, 85 T.C. 1075 (1985), aff'd, 812 F.2d 158 (4th Cir. 1987).

The Commissioner "may insist upon full compliance with his regulations" when the regulatory requirements relate to the substance or essence of a statute. Angelus Milling Co. v. Commissioner, 325 U.S. 293, 296 (1945); Dunavant v. Commissioner, 63 T.C. 316 (1974). Thus, courts have refused to recognize literal compliance in certain situations. For example, in Atlantic Veneer, supra, the court found in construing the provisions of Internal Revenue Code §§ 754 and 743 that absent a formal election, a submitted return and attached schedules must evidence an affirmative intent by the taxpayer to make the required election and be bound thereby. Moreover, failure to manifest such intent resulted in rejection of an alleged election. This court decided that the documents constituting the taxpayer's return did not make clear that a valid election was made to step up basis of a [redacted] partnership's assets for United States tax purposes, finding it "extremely difficult" to extrapolate data from another document. As part of its reasons for finding lack of a valid election, the court noted that the taxpayer could easily have attached a statement affirmatively specifying that it was making an election under § 754. See also Fischer Industries, supra.

The Tax Court has consistently recognized the Commissioner's right to insist upon full compliance with his regulations when the regulatory requirements relate to the substance or essence of a statute. However, the Tax Court has allowed substantial compliance with regulatory requirements to suffice when such requirements are procedural and the essential statutory purposes have been fulfilled. American Air Filter Co. v. Commissioner, 81 T.C. 709 (1983). The Tax Court commonly employs five factors in determining whether to permit less-than literal compliance with regulatory requirements, namely: (1) whether the taxpayer's failure to comply fully defeats the purpose of the statute; (2) whether the taxpayer attempts to benefit from hindsight by adopting a position inconsistent with this original action or omission; (3) whether the Commissioner is prejudiced by the untimely election; (4) whether the sanction imposed on the taxpayer for the failure is excessive and out of proportion to the default; and (5) whether the regulation provided with detailed specificity the manner in which an election was to be made. Id., at 719-720. Further, several appellate courts have held that the common law doctrine of su~~tantial compliance should not be allowed to spread beyond cases in w) the taxpayer had a good excuse (though not a legal justification) for fa..ing to comply with either an unimportant requirement or one unclearly or confusingly stated in the regulations or statute. See, e.g., Prussner v. United States, 896 F.2d 218, 224 (7th Cir. 1990), and McAlpine v. Commissioner, 968 F.2d 459, 462 (5th Cir. 1992).

A related regulatory goal is that the Commissioner actually know whether an election has been made as such knowledge ultimately serves the policy of minimizing disputes between a taxpayer and the Service. In addition, informing the Commissioner of an election aids in assessing whether the system is being abused. Moreover, the Commissioner needs to know an election has been made so he may determine whether an audit is necessary at all and, if so, the scope of such audit. Knight-Ridder Newspapers, supra.

However, under other circumstances, courts have held that taxpayers had substantially complied with the requirements for an election despite their failure to meet the literal requirements. In these instances, courts looked to see whether specific requirements related to the "essence" of the statutory and regulatory scheme. If the requirements were not essential to the tax scheme, then literal compliance with the requirements was not required. Thus, "In ascertaining whether a particular provision of a regulation stating how an election is to be made must be literally complied w , it is necessary to examine the purpose, its relationship to other p isions, the terms of the underlying statute, and the consequences of failure to comply with the provision in question." Hewlett-Packard v. Commissioner, 67 T.C. 736, 749 (1977), acq. in result only, 1979-2 C.B. 2 (1979).

In our view, the unambiguous § 1.451-5(d) information disclosure regulation relates to the "essence" of the accounting method statutes. Its purpose is to demand specific, contemporaneous and incontrovertible evidence of the taxpayer's adoption and consistent use of a special method of accounting for a particular class of income. Therefore, substantial compliance with § 1.451-5(d) is required. Accordingly, in our opinion, [redacted] failed to properly elect the benefits of income deferral because:

1. The taxpayer clearly understands the importance of filing an election where required as it attached two elections, to change its method of accounting for depreciation and to elect an initial classification for a foreign eligible entity to be disregarded as a separate entity. There appears to be no reason why the taxpayer could not have filed with its original Form 1120 the statement required by Treas. Reg. § 1.451-5(d). Further, to date the taxpayer has still not filed the required statement. Nor do we accept the taxpayer's position that it has supplied the necessary information during the audit. We understand that the submission consists of a one-page listing of the [redacted] gift certificate activity. Yet that l ng has not allowed the revenue agent to determine how much income has be . reported despite her repeated efforts to reconcile the taxpayer's

records to the Form 1120.

_. Similarly, the subject Form 1120 does not demonstrate any intent to make the deferral election. The Statements attached to the return list several different types of other income but provides no information allowing the Service to determine whether **any** gift certificate income has been reported. Yet, the taxpayer kept sufficiently accurate records to report $[redacted] of miscellaneous income for one subsidiary. In our opinion, nothing on the return would inform the Service that [redacted] had properly deferred the gift certificate advance payments or intended to defer such income. See Atlantic Veneer, supra; Kosonen v. Commissioner, T.C. Memo. 2000-107 ("A taxpayer has not made an election if it is not clear from the return that an election has been made.")

3. The taxpayer's failure to provide the required information would defeat the general rule of § 446. Based on the information available to the Service, we conclude that [redacted] accounting method does not clearly reflect income and does not match income and deduction. Accordingly to its own response to the IDR in paragraph 4., the taxpayer has expensed gift certificate discounts while not clearly reporting any gift certificate income. Further, since items of gross income shall be included in gross income for the taxable year in which received unless the taxpayer has demonstrated it is entitled to a deferral, [redacted] failure to comply with the requirements of § 1.451-5(d) would defeat the general rule of § 451. In addition, this is not a situation where a taxpayer's return entries have highlighted the taxpayer's methodology or put the Commissioner on notice of potential errors and omissions. Moreover, permitting [redacted] to utilize a hidden method of accounting for a particular category of income would substantially short circuit the Commissioner's audit return selection and issue identifications procedures, while making a prolonged audit necessary.

4. Clearly, the Commissioner would be prejudiced by the taxpayer's failure to comply with the regulation. As in Knight-Ridder, the significance of the election at issue here reaches beyond the year under audit as the taxpayer itself claims to have used the same method of deferring income for more than ten years.

5. Requiring the taxpayer to report income received in [redacted] in that taxable year does not appear to be a harsh or excessive sanction, especially since the taxpayer has a relatively long history of improperly deferring taxable income and has made no attempt to comply with the regulation.

6. The taxpayer has claimed oversight as the reason for its failure to comply with § 1.451-5(d). We doubt that this is a sufficient reason for expanding the common law doctrine of substantial compliance. See Prussner, supra; Estate of Chamberlain v. Commissioner, T.C. Memo. 1999-181 (no defense of substantial compliance for a failure to comply with the essential statutory requirements).

summary, we believe that the Commissioner is entitled to insist upon full compliance with Treas. Reg. § 1.451-5(d).

This opinion is based upon the facts set forth herein. It might change if the facts are determined to be different. If the facts change, this opinion should not be relied upon. Please note that under routing procedures which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office, which should be in approximately 10 days. In the meantime, the conclusions reached in this memorandum should be considered to be only preliminary.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions on this memorandum, please contact Diane Mirabito at [redacted].

JODY TANCER
Associate Area Counsel
(Large and Mid-Size Business)

By:____________________
DIANE R. MIRABITO
Attorney (LMSB)